How might CDC develop in the UK?

PENSIONS POLICY INSTITUTE

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Introduction

After years of legislation and preparatory work, the first UK CDC scheme, provided by the Royal Mail, is expected to enter the pensions landscape by the end of the year, although the exact date is not yet known. However, it is unclear what the future holds for CDC in the UK, beyond the establishment of the Royal Mail scheme.

This Briefing Note sets out the current position of CDC in the UK, including its development, current rules and regulations, and a case study on the Royal Mail scheme. It then explores the potential for future development of CDC in the UK context, highlighting potential benefits and opportunities, challenges and risks, and the scope for alternative scheme design, including multi-employer and decumulation-only CDC schemes.

This Briefing Note has been informed by interviews with a broad range of stakeholders from across the pensions industry, including international experts, and adjacent stakeholders, such as employers and unions. We extend our gratitude to all those who participated.

Key Findings

- Aside from the imminent Royal Mail scheme, it is currently unclear how CDC development will progress.
- Appetite for CDC schemes is currently limited, with the exception of Royal Mail, although some schemes, employers and providers are investigating its potential. There may be greater appetite for CDC schemes with alternative designs to the current single-employer model, including multi-employer and decumulation-only CDC schemes.
- CDC schemes could offer a number of potential benefits and opportunities, particularly for members, but also for employers and providers. However, some features of CDC schemes and the way they interact with the wider pensions landscape may impact the adoption of CDC, although many of these challenges are not unique to CDC.

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CDC is a new form of pension scheme in the UK which offers an alternative balance of risk to existing Defined Benefit (DB) and Defined Contribution (DC) schemes

CDC schemes have two defining features:

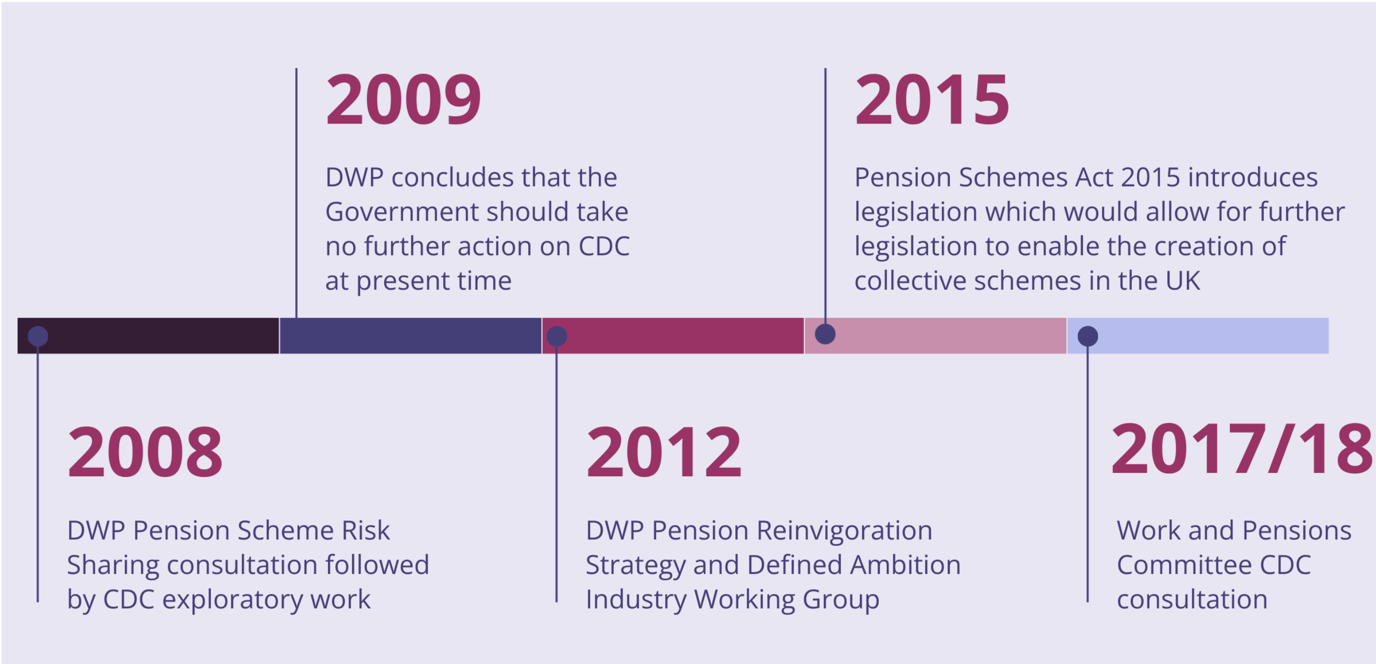
- Collective: Risks are shared collectively between the scheme's members rather than individually.
- Defined Contribution: Contribution rates (employer and employee) are defined in advance, with no ongoing liability to pay more in the future to cover benefits.

CDC schemes provide members with an income for life in retirement, rather than the pot of savings accrued in a DC scheme. However, unlike DB schemes in which the level of income entitlement is guaranteed, entitlement in CDC schemes can be adjusted up or down in response to the scheme's funding position in order to maintain a defined level of contributions; in this way, risks are shared across members rather than falling upon the employer.

The process to enable CDC schemes to open officially began around six years ago, but discussion of CDC as an option can be traced back further

The potential for CDC or similar collective arrangements has been explored in the UK context from as early as 2008. The Pension Schemes Act 2015 introduced the possibility of further legislation to enable collective schemes, such as CDC, although the legislation set out a framework for broader Defined Ambition schemes rather than CDC specifically. However, in 2015, the introduction of such collective schemes was considered a 'niche interest', and therefore not a policy which would impact a large proportion of savers, unlike automatic enrolment and pension freedoms which would have more immediate implications for millions of people. As a result, the Work and Pensions Committee recommended that the Department for Work and Pensions (DWP) ensure resources were not diverted towards the development of risk-sharing schemes until automatic enrolment was fully rolled out and the pension freedoms properly established.[1] For a more detailed description of the history of CDC development in the UK pre-2018, see PPI (2018) What is CDC and how might it work in the UK? (Figure 1).

Figure 1: UK CDC development 2008-2018

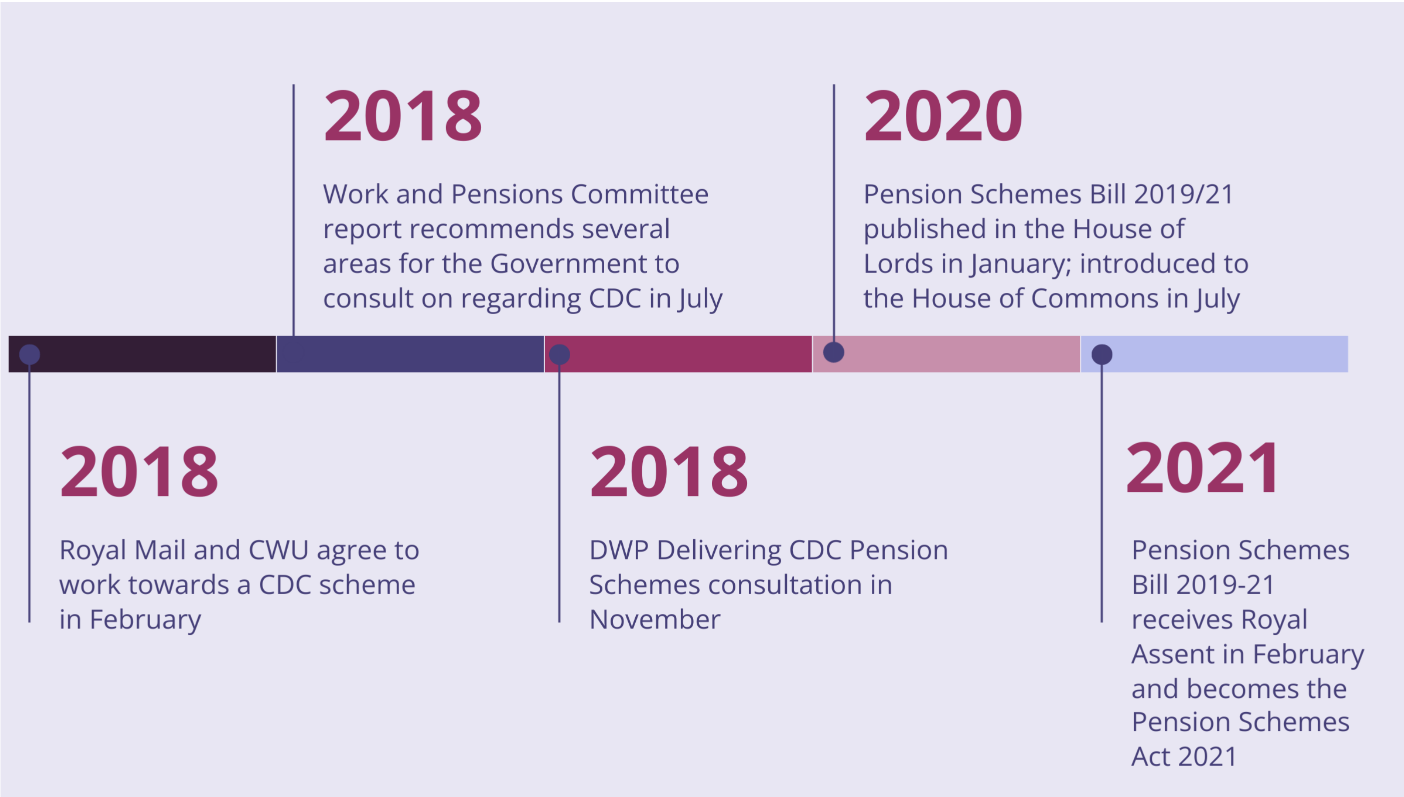


[1] Work and Pensions Committee (2015) Progress with automatic enrolment and pension reforms

In 2018, Royal Mail and the Communication Workers Union (CWU) agreed to pursue a CDC scheme as a replacement for Royal Mail's DB scheme, which closed to future accruals in its previous form in March of that year. The Royal Mail decision, which came three years after the introduction of the pension freedoms and six years after the introduction of automatic enrolment, acted as a catalyst, bringing CDC back to the forefront of policy discussions. In November 2018, DWP published a consultation on 'Delivering Collective Defined Contribution Pension Schemes', which highlighted a number of key issues to be considered in relation to CDC.

The consultation was followed by the introduction of primary legislation, in the form of the Pension Schemes Bill 2019-21. Uncertainty and prioritisation of more immediately pressing policy concerns resulting from the pandemic delayed the progression of the Bill. The Bill received Royal Assent in February 2021, becoming the Pensions Schemes Act 2021 (Figure 2).

Figure 2: UK CDC development 2018-2021



Primary legislation and regulations are now in place to allow CDC schemes to enter the UK pensions landscape

The Pension Schemes Act 2021 set out the framework for CDC in the UK

The Pension Schemes Act 2021 provides a framework for the establishment, operation and regulation of CDC schemes in the UK. The Act clearly defines CDC as DC, referring to it as 'collective money purchase', and sets out parameters for future CDC schemes, including:

- Authorisation: all CDC schemes must be authorised by The Pensions Regulator (TPR) before they can open to members and begin operation. In order to receive authorisation, schemes must satisfy a number of criteria (explained on the next page).
- Valuation and benefit adjustment: schemes must set out in their rules how the rate or amount of benefits provided by the scheme is to be determined – this must include rules for determining the available assets of the scheme and their value, and rules for determining how benefits will be adjusted and under what circumstances.

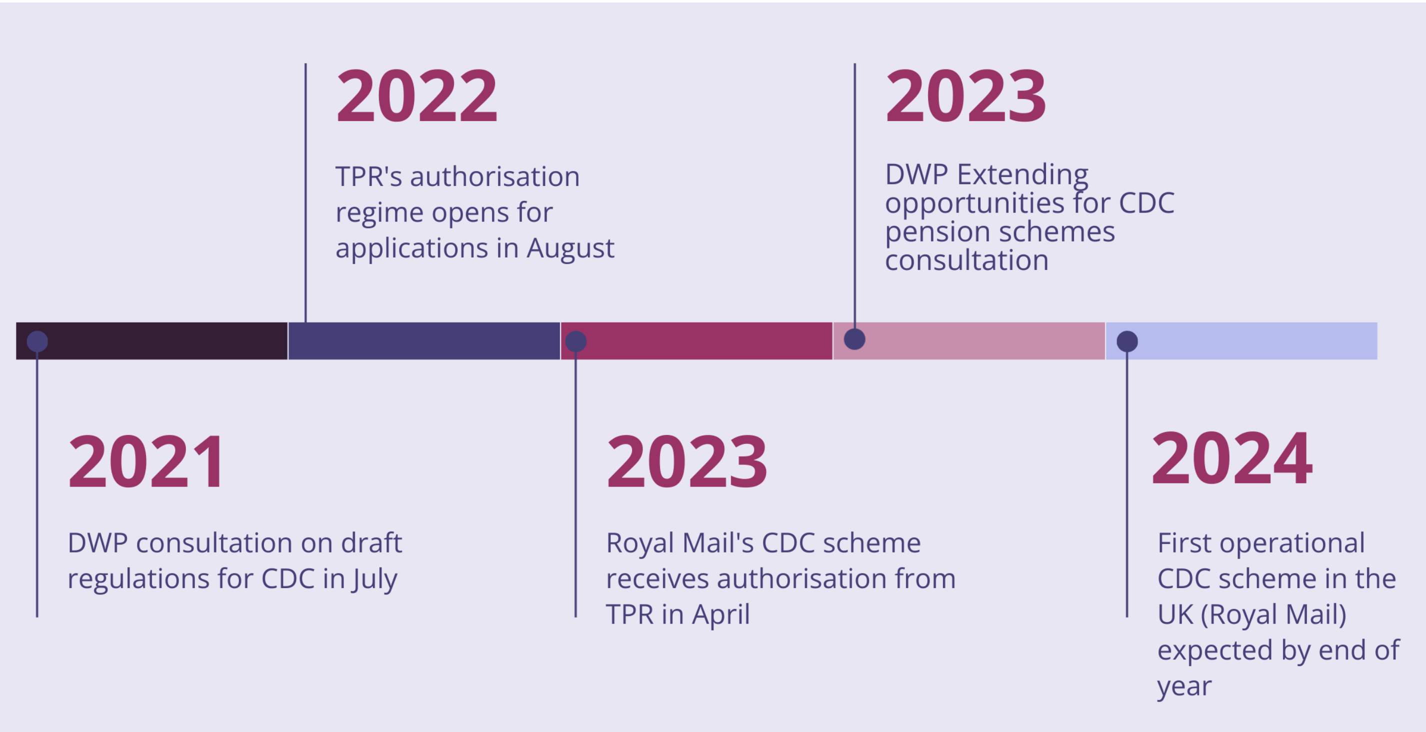
- Member rights: existing DB benefit entitlements cannot be converted into CDC entitlements and members of CDC schemes are entitled to transfer out
- Triggering events and continuity options: in the case of a triggering event, such as insolvency of the connected employer or deauthorisation by TPR, schemes must follow continuity options prescribed by the legislation, either resolving the triggering event, winding up of the scheme or converting it to a closed scheme, depending on the nature of the triggering event

The Act also includes provision to extend CDC regulations in future beyond the single-employer schemes currently allowed by the legislation.

TPR's authorisation process aims to ensure that CDC schemes are effectively administered and governed

Following a consultation on draft regulations in 2021, TPR's authorisation regime opened for applications in August 2022 (Figure 3). Broadly speaking, the authorisation process is similar to the master trust authorisation regime that was already in place, but with some criteria which are specific to CDC schemes.

Figure 3: UK CDC development 2021-present



CDC schemes seeking authorisation must satisfy six key criteria:

- Those involved in the scheme are fit and proper persons for carrying out the required duties.
- The scheme has IT systems and governance processes in place that are sufficient to ensure that it is run effectively and complies with all relevant legislation and regulation.
- The scheme must have appropriate systems and processes to communicate with members so that they understand the risks and benefits of the scheme, in particular how their benefits may be adjusted.
- The scheme must have a robust continuity strategy which sets out how members will be protected if there is a triggering event.
- The scheme must have sufficient financial resources to both set up and operate sustainably on an ongoing basis, as well as to pay for a continuity option from the point of authorisation.
- The design of the scheme must be sound, demonstrated by the viability report and viability certificate signed by the scheme actuary submitted as part of the authorisation process, and supported by evidence, including appropriate advice from suitably qualified professionals, as well as modelling and testing.

Prospective schemes are encouraged to engage with TPR before submitting a formal application for authorisation. To date, only one CDC scheme has been authorised by TPR, the Royal Mail Collective Pension Plan (Figure 4).

Figure 4: Royal Mail case study

In March 2018, Royal Mail's Career Average DB scheme was closed to future accrual due to the rising cost of providing it. Royal Mail stated that if no changes were made, its pension contributions would have had to increase from around £400 million a year to over £1.2 billion. The employer contribution was 17.1% of salaries when the scheme was closed, but if accrual had continued, contributions would have had to increase to over 50% of salary from April 2018. This was unaffordable for Royal Mail and an alternative solution had to be found.

Having engaged in detailed discussions with the CWU about future pension arrangements, it was agreed that a CDC scheme could best meet objectives going forward by providing better expected outcomes and more predictable costs for employees and employers.

A transitional DB cash balance scheme (in which the defined benefit promised to members is not an income but a lump sum, which most members could use as their 25% tax free lump sum) was put in place as an interim measure while Royal Mail and the CWU worked together with Government to introduce the necessary legislation to enable CDC in the UK.

The Royal Mail Collective Pension Plan received authorisation from TPR in April 2023 and is expected to open to members in 2024, although the exact date is not yet confirmed.

The accrual rates have been designed to be close to those of the previous DB scheme, while also taking into account budget constraints. The scheme's approach to contributions, investment and benefit adjustments has been designed through rigorous simulation and scenario testing.

The scheme is comprised of two sections:

- A DB Lump Sum section, accruing at 3/80th of pensionable pay. The lump sum is guaranteed not to go down and annual increases are discretionary and based on performance of the assets.
- A CDC section, accruing at 1/80th of pensionable pay, adjusted annually based on the performance of the assets.

Scheme contribution rates are 13.6% for employer and 6% for employee. The rate of contribution and accrual is the same for all members.

Adjustments will also be the same for all members, whether they are in accumulation or decumulation. Modelling suggests that average long-term increases could be in line with the Consumer Prices Index (CPI) +1%, but these are not guaranteed and will depend on the scheme's funding position. Where possible, benefits will be adjusted through lower future increases rather than nominal cuts, which modelling suggests would only be required in extreme circumstances.

Stochastic modelling using historical investment data from the last 100 years found that nominal cuts would only have been necessitated in the 1930s Great Depression. At all other times, reductions in future increases would have been enough to manage the funding position. However, it is acknowledged that future market performance will be different to past performance, so the scheme has been designed to be resilient to market movements, with the mechanisms to decrease pensions or award increases below inflation.

At set up, the scheme includes an escrow reserve to cover costs in the potential event of scheme wind-up. Over time this escrow will be replaced by a continuity reserve.

Communication to members will focus on the variable nature of benefits, rather than specific targets for benefit increases, with the key message being that benefits can be adjusted up or down but will aim to help keep pace with increases in the cost of living. The scheme is focusing on ensuring communications are clear and simple, including not being too text-heavy, utilising images where possible and using accessible language that members should be able to understand. Communications will also include illustrative scenarios to help members understand how adjustments to benefits could be made in response to different circumstances.

The scheme has been designed to meet the objectives agreed between Royal Mail and the CWU. Other parties interested in CDC are likely to look to the Royal Mail scheme as a guide and may even seek to employ the same advisors and technical experts that have been utilised in the scheme's design. However, the specific design of the Royal Mail scheme is not the only possible scheme design allowed within the UK legislation and other designs may better meet alternative objectives.

Aside from the imminent Royal Mail scheme, it is currently unclear how CDC development will progress

The role CDC will play in the UK pensions landscape going forward is not yet clear. The remainder of this Briefing Note explores the factors that are likely to shape the future of CDC in the UK, including:

- the benefits and opportunities that could be offered by CDC
- current appetite for CDC among both DB and DC schemes
- alternative scheme designs that may be introduced in the future
- the challenges and risks that may hinder the growth of CDC

CDC schemes could offer a number of potential benefits and opportunities

There is widespread recognition of the potential benefits and opportunities that CDC could offer, although some stakeholders question whether all of these benefits are unique to CDC or whether they could be achieved through innovation within existing schemes. The benefits of CDC depend to some extent on the current position, whether the existing provision is DB or DC, and whether one is considering the member position or scheme/provider/employer perspective (Figure 5). While CDC has the potential to offer benefits to both members and employers, these should be viewed within the context of the broader pensions landscape and potential challenges that CDC may face, which are discussed later in this Briefing Note.

Figure 5: Potential benefits of CDC

For members:

- Potential for higher incomes than DC, DB or annuity
- More predictable retirement incomes than DC
- Protection against longevity risk as a result of collective risk sharing
- Less engagement or individual decision making needed to achieve positive outcomes than DC

For employers/providers:

- A more cost-effective way to provide members with an income in retirement
- Employer does not bear the risks associated with DB
- Providing an income in retirement for the same contribution as DC

CDC schemes have the potential to provide members with better retirement outcomes

The extent to which members could benefit or would perceive themselves as benefiting from the transition to a CDC scheme is dependent on their existing pension provision. For members of a DB scheme, CDC may be less appealing as they are losing the guarantee of a set amount of income. However, if the funding position of their DB scheme necessitates its closure, CDC is likely to be a preferable option to DC, especially if they are to be moved into a CDC scheme that has been intentionally constructed to align as much as possible to the previous DB arrangement, as has been done by Royal Mail.

It is suggested that CDC schemes will be able to take a longer-term investment strategy than DC schemes as a result of collective risk-sharing across a mix of members in both accumulation and decumulation. Collective investment across both active (and deferred) and retiree members should allow the scheme to remain invested in growth-seeking assets for longer without the need to shift towards more secure assets (glide path approach) as individual members approach retirement. PPI modelling of a hypothetical CDC scheme illustrated that a 10% contribution rate could produce a replacement rate of between 27% and 30%, compared to 12% to 21% in a DC scheme.[2]

The potential for higher retirement incomes in CDC schemes has been demonstrated by a number of other modelling studies, for example:

- Aon used past performance to illustrate that CDC schemes could provide retirement incomes around a third higher than a CPI-linked annuity purchased using DC savings invested using a lifestyle approach.[3]
- Willis Towers Watson, advisors for the Royal Mail scheme, compared projected CDC incomes to those of annuities and DB. Based on their analysis, income from a CDC scheme would typically be expected to be, on average, 40% higher than income from a DB scheme and around 70% higher than an insured annuity, for the same contribution.[4] Lower incomes from DB and annuities result from the higher cost associated with providing a guaranteed level of income, while CDC income can be adjusted to mitigate changes in funding position.

[2] PPI (2015) Modelling Collective Defined Contribution Schemes
[3] Aon (2013) The case for Collective DC
[4] Willis Towers Watson (2020) A guide to CDC pensions

The magnitude of higher incomes in CDC compared to DC will depend on the scheme's chosen investment strategy. While CDC schemes may be able to allocate more to growth-seeking assets for longer, this could be tempered by conservatism within chosen investment strategies in order to have greater predictability of member outcomes. While CDC schemes in the UK will differ from those observed overseas, asset allocation of existing CDC schemes in other countries are similar to those of DB schemes, with a lower allocation to growth-seeking assets than DC schemes on average.[5]

As well as potentially higher retirement incomes, CDC schemes could enable members to achieve positive retirement outcomes without having to make complex decisions about how much to save, how to invest (although most remain in the default strategy) and how to access their savings. CDC schemes are likely to require less engagement and decision making from members than DC in order for them to achieve positive retirement outcomes, as they provide members with an income for life. Decisions about how to save for and access retirement savings are complex. While engagement strategies can support some people to achieve positive retirement outcomes, knowledge and behavioural barriers make it more challenging for some people to make informed active choices that are likely to deliver positive retirement outcomes, and are therefore at greater risk of experiencing poor retirement outcomes without more structured support.[6] The 2018 consultation from DWP suggested that CDC schemes can 'provide a savings and income in retirement option within one package that is potentially attractive to those people uncomfortable making complex financial decisions at the point of retirement'.[7]

The protection against longevity risk provided by CDC further simplifies the decisions members will have to make, comparative to DC. DC savers will have to make complex choices at, and during, retirement about how to spread their pension savings over the entirety of retirement to ensure that they do not run out of money and end up solely dependent on the State Pension in their later years, without knowing precisely the length of retirement they will experience. There is also a risk of underspending if individuals are overly cautious about longevity risk. Purchasing an annuity with DC savings removes this longevity risk of outliving pension savings by providing a guaranteed income for life. Similarly, members of DB schemes are protected from longevity risk. The collective nature of CDC schemes entails the sharing of longevity risk between members, with members who don't live as long subsidising members who live longer, providing each individual member with an element of longevity protection as they will receive an income for the entirety of their retirement.

CDC schemes could provide a more cost-effective way for employers to provide their employees with an income in retirement

For employers offering DB provision, CDC could be a more cost-effective way to provide their employees with an income in retirement. The primary driver of the decline of DB schemes has been the increasing and uncertain cost of delivering such provision. CDC offers an alternative way to provide employees with an income in retirement, without the employer accepting the uncertainty and risk which have made DB less attractive. Contributions are fixed and employers will not be called upon to make additional contributions if investments perform less well than expected. Any shortfalls in scheme funding will instead be managed by adjusting member benefits.

For employers offering DC provision, there may be an expectation that CDC will be inherently more expensive than providing DC, which could deter them from transitioning to CDC. However, the contribution rate does not necessarily need to be higher in order for CDC to deliver potentially better outcomes for members, as illustrated by the modelling outlined above, in which CDC schemes provide a higher replacement rate than DC for the same contribution rate.[8]CDC schemes have the potential to enable employers currently offering DC provision to provide their employees with a more generous benefit for the same level of contribution. However, there is unlikely to be the same urgency to open a CDC scheme among DC employers as there may be for employers looking to close a DB scheme, although this may change as multi-employer schemes join the market. Governance, administration and operation costs may be higher for CDC than DC, which may deter employers currently offering a DC scheme to transition to CDC.

[5]Nest (2014) The future of retirement consultation
[6]PPI (2024) What could effective pensions engagement look like?
[7]DWP (2018) Delivering Collective Defined Contribution Pension Schemes
[8]PPI (2015) Modelling Collective Defined Contribution Schemes

Appetite for CDC schemes is currently limited, with the exception of Royal Mail

While both legislation and TPR's authorisation process are now in place to enable CDC schemes run by single or connected employers to enter the UK pensions landscape, to date only one scheme (Royal Mail) has received authorisation and is yet to open to members. Although a number of organisations are currently evaluating the potential of CDC, no other providers or employers have publicly declared their intention to establish a CDC scheme, and most employers, when asked in 2022, were not aware of CDC schemes as a new pension scheme type, although there is some interest among those who are aware.[9]

Appetite for CDC, influenced by potential benefits and the challenges that may hinder adoption, will vary according to scheme type and size.

CDC schemes could be an appealing alternative for remaining DB schemes, but the transition may be challenging unless it is not feasible to continue with existing DB provision

DB schemes may seem like the most natural candidate for the transition to CDC. While categorised as DC in legislation, the benefits provided by a CDC scheme are more closely aligned to the income provided by DB than the pot of savings produced through traditional DC schemes.

The majority of private sector DB schemes have now closed to new members, future accruals or been wound up entirely. As of March 2023, there are 5,051 private sector DB schemes, just 9% of which are open to new members; a further 36% are closed to new members but open to new benefit accrual for existing members, while 52% are closed to both new members and new accruals, and 3% in the process of winding up.[10]

CDC may present an alternative option for DB schemes that remain, but, as the decline of DB has accelerated, the pool of remaining schemes is now limited and there are few with a workforce of a comparable size to Royal Mail. Among the schemes that remain, recent market changes have led to improved funding positions, which may subdue the rate of scheme closures in the near future. Increases in long-term gilt yields have led to a decrease in the value of DB liabilities.

There may be appetite among some large employers with enduring DB provision, but it may be tempered by the view that it is prudent to wait until the Royal Mail scheme is operational. While some may already be engaging in exploratory work, they are unlikely to announce this publicly until they are certain of their intentions.

While unions may object to the closure of DB schemes, a transition to CDC may be a more palatable option than DC if there is no feasible option for maintaining existing DB provision. The process of collaboration between Royal Mail and its employees' union, the CWU, emphasises the role that CDC may play as a compromise for DB schemes that will close, as it is likely to be a preferable option to DC. However, there is still likely to be some union and member pushback as the guarantee of DB will be viewed as preferable to CDC, despite the potentially higher incomes modelling suggests it may provide.

CDC may have a less obvious appeal to employers and providers of DC schemes, but there is potential for it to improve retirement outcomes for members

Due to the decline in private sector DB schemes and the introduction of automatic enrolment, DC schemes now account for a greater proportion of UK pension provision. In 2023, there were around 710,000 active members in private sector DB schemes and a further 7.2 million in public sector DB schemes, compared to around 14 million active members in DC workplace pension schemes.[11] Given the balance of active memberships between DB and DC, in order for CDC to become a significant vehicle of pension provision in the UK, at least some DC schemes would also need to make the transition.

[9] DWP & Government Social Research (2022) Workplace pensions and Automatic Enrolment: Employers' perspectives 2022
[10] PPF (2023) The Purple Book 2023
[11] PPF (2023) The Purple Book 2023; TPR (2024) Occupational defined benefit (DB) landscape in the UK 2023; PPI analysis of the Wealth and Assets Survey (Round 7)

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There has been significant regulatory and market change in recent years which has required considerable work from employers to ensure that they are compliant. Employers who have recently made the transition from DB to DC may be reluctant to make another major change to transition to CDC. Other employers who were not providing a pension scheme for their employees prior to the introduction of automatic enrolment may feel similarly reluctant to open a new scheme so soon after making arrangements to comply with the new regulations. Perhaps if CDC had been an option at the time when automatic enrolment was introduced, some employers may have chosen to offer it instead of DC, but now that they have DC arrangements in place, they will maintain their current arrangements. There is, however, a question around how much overlap there would have been between those employers who were not offering any pension provision pre-automatic enrolment and those who may have an interest in CDC, so this may not have had much impact in practice. However, for employers seeking to optimise benefits within budget constraints, CDC could present a more cost-effective way to provide employees with a more generous retirement benefit.

Further appetite for CDC may not materialise until the Royal Mail scheme is embedded within the system

Concerns around being an early adopter of CDC may be subduing demand among both DB and DC schemes, providers and employers. If others are waiting to assess the success of the Royal Mail scheme before making a definitive decision, it is unclear what the time parameters might be, either once the scheme is opened or after it has been running successfully for a longer period.

Some stakeholders have expressed concerns about the potential for regulatory evolution which could introduce greater prescription and more definitive guarantees for CDC schemes in the future, although the legislation has been clearly set out to define CDC schemes as DC. Again, some employers who may have an interest in transitioning to CDC, may be waiting to see how the regulatory regime works in practice once the Royal Mail scheme is operational, although there can be no guarantee against future regulatory changes. The potential introduction of multi-employer CDC schemes in future, discussed in a subsequent section of this Briefing Note, could help to mitigate concerns about regulatory evolution as there would not be the same dependence on a single employer and therefore employers would be exposed to lower levels of risk.

There may be greater appetite for CDC schemes with alternative designs to the current single-employer model

Current legislation only allows for CDC schemes relating to a single employer or connected group of employers. However, the legislation also includes provision to extend CDC regulations in future to include multi-employer schemes. In 2023, DWP consulted on ‘Extending Opportunities for Collective Defined Contribution Pension Schemes’. Prior to the consultation, DWP had conducted around thirty individual discussions with a wide range of organisations interested in forms of CDC scheme other than the single-employer model, including master trust providers, unions, insurance companies, consultancy firms, academics and pension providers, to explore what these alternative forms of CDC schemes might look like.[12] The consultation focused primarily on the introduction of multi-employer whole-of-life schemes and decumulation-only schemes, but also acknowledged other features of design where there is interest in greater flexibility, including:

- differing contribution or accrual rates; and
- flexibility to vary contribution (and accrual) rates over the lifetime of the scheme if the actuarial conversion factors are consistent.

[12] DWP (2023) Extending Opportunities For Collective Defined Contribution Pension Schemes

The consultation concluded that while there are many similarities with the single-employer scheme design currently legislated for, and therefore the existing regulatory framework can be adapted to accommodate new scheme designs, these alternative scheme designs present new challenges that will need to be accounted for. A further consultation on draft regulations for multi-employer CDC schemes is expected in 2024.

Multi-employer CDC schemes may generate more interest from employers, particularly those without the scale to establish their own scheme

There may be more appetite among providers for multi-employer whole-of-life and decumulation-only CDC schemes. Employer appetite for CDC might increase as multi-employer provider offerings become available, legislation allowing, as the cost and risk to the employer is likely to be less than establishing their own single-employer scheme, and will also allow for scale that many employers will not be able to achieve on their own. Once legislation is in place to allow for multi-employer CDC schemes, existing DC master trusts could offer a CDC fund alongside current offerings for existing members either as an option for members to opt into or as the default fund. However, multi-employer schemes may also experience the same effect as single-employer schemes in terms of concerns around being an early adopter. Some stakeholders highlighted the potential role of Nest as an early adopter to expand CDC provision to a wider membership base if other providers are hesitant to be the first to make the transition.

Decumulation-only CDC schemes could be appealing to DC savers seeking an alternative income option in retirement

Decumulation-only CDC schemes should be able to fulfil their objectives while operating under current design constraints. A decumulation CDC scheme would offer longevity risk pooling between members, unlike individual drawdown, and a higher degree of investment in growth assets than an annuity. They could therefore offer a higher, if slightly more volatile, income for life than an annuity, without the risk of fund exhaustion associated with drawdown.[13]

While the recent DWP consultation on Extending Opportunities for CDC Pension Schemes highlighted demand for both multi-employer whole-of-life schemes and decumulation-only schemes, it stated that detailed proposals for the latter were yet to emerge.[14] There are some concerns that the time might not be right to introduce decumulation-only CDC options. Current DC savings levels are relatively low and therefore unlikely to be high enough to secure an adequate income through a CDC scheme, although even for those with relatively low levels of pension savings, the income for life provided by CDC could be an attractive option. Once the DC market is more mature, with savers having accrued higher levels of average savings, it might be a natural progression for master trusts to offer CDC decumulation options. This may be dependent on building consensus to move back towards income-focused saving and decumulation products, which are currently underutilised by savers accessing their DC savings. Consumer research suggests that CDC could be an appealing decumulation option for a significant proportion of DC savers, with around 30% of people surveyed preferring the features of CDC decumulation to currently offered annuities and drawdown products.[15] Given the lengthy process to put legislation in place to enable whole-of-life CDC schemes, in order for CDC decumulation options to be ready for the maturing DC market, early discussions may be needed some time before people begin to retire with more substantial levels of DC savings.

[13] PPI (2023) The role of Collective Defined Contribution in decumulation
[14] DWP (2023) Extending Opportunities for Collective Defined Contribution Pension Schemes
[15] Aon & Aegon (2023) Collective DC Decumulation: Is There Demand?

Some features of CDC schemes and the way they interact with the wider pensions landscape may impact the adoption of CDC

Concerns around timing, particularly being an early adopter of CDC, the considerable work undertaken to comply with recent regulatory changes, and uncertainty about how the regulatory regime may evolve over time, may be the primary factors discouraging wider adoption of CDC at present. While these factors may ease with time, there are other challenges and risks, more fundamental to the design of CDC schemes and the broader UK pension landscape, that may impact adoption of CDC.

Ensuring that members understand the benefits and risks of a CDC scheme will be challenging, but this challenge is not unique to CDC

Because of the variable nature of benefits within CDC schemes, clear communication of scheme rules is especially important. Communications must ensure that members understand the nature of their income entitlement within the scheme and the possibility that this could be reduced under some circumstances. Scheme communications will need to be explicit about the potential risks associated with future indexation and benefits, and clearly explain to members the measures that will be taken by trustees to address any changes in the scheme funding position.

Concerns around the challenges of communicating with members of CDC schemes should, however, be viewed within the context of low levels of engagement and understanding across the whole pensions landscape. Many members of existing DB and DC schemes have a very limited understanding of the technical workings of their scheme, so members of future CDC schemes should not be expected to have a thorough understanding of this. Members of CDC schemes will primarily want to know the income they can expect to have in retirement, the circumstances under which it will be adjusted up or down, and their rights in relation to transfer, flexibility and inheritance etc. For most members, as long as they know that the scheme is being run fairly by competent individuals, which is a requirement for scheme authorisation, they will not be interested in knowing the details of actuarial processes or investment strategy that underpin the scheme. As with many of the other potential challenges outlined in this Briefing Note, this is not unique to CDC, as DC and DB schemes also include risks of which members may not have a thorough understanding.

The potential for inequality between and within cohorts of members in CDC schemes means they must be carefully designed to ensure that members are treated equitably

An amendment to the Pension Schemes Act 2021 was considered, requiring trustees to assess whether their scheme operated in a way that was fair between different groups of members. The amendment was ultimately removed at the Committee stage in the House of Commons, with then Minister for Pensions and Financial Inclusion, Guy Opperman, explaining that if the Bill '*provides specifically for fairness, it may be open to interpretation and mean different things to different people. The legal advice we have received is that it would be inappropriate to include that in the Bill, and that it is far better to address the matter in detailed regulation rather than through a single word in the confines of the Bill.*'[16]

It was determined that a 'best estimate' approach that does not rely on capital reserves (buffers) would be the best way to mitigate the potential for intergenerational unfairness. While buffers have been utilised in international CDC schemes, UK schemes will pay out benefit levels based on the current total value of the fund, without reserving some of it to use as a buffer to protect against potential future cuts.[17]

[16]Pension Schemes Bill debate 3 November 2020 https://hansard.parliament.uk/commons/2020-11-03/debates/5fb13a14-edaf-4e29-9d9a-1f2e415e327c/PensionSchemesBill(Lords)(FirstSitting); Mirza-Davies (2022) Pensions: Collective Defined Contribution (CDC) schemes [House of Commons Library]

[17]DWP (2019) Government Response: Delivering Collective Defined Contribution Pension Schemes

The UK CDC system will aim to minimise challenges of intergenerational unfairness using three core principles set out in the Pension Schemes Act 2021:

- Adjustments to benefits required by under or over funding take place frequently, for example annually;
- All cohorts of members are treated the same when adjustments are made; and
- Adjustments to benefits are not smoothed using buffers, with valuations being undertaken using a best estimate approach that does not seek to be overly optimistic or build in prudence.

While UK CDC legislation minimises the potential for intergenerational inequality between different cohorts, because there are socio-economic differences in life expectancy, there could also be issues of socio-economic inequality associated with CDC. Here, lower earners would, in effect, subsidise the pensions of higher earners in their scheme, who are likely to receive payments for a longer period. For contributions made at a set percentage of salary, the assets in the scheme may end up being used disproportionately to pay pensions to higher-income members. It is an inherent consequence of longevity risk sharing that some members will benefit to a greater degree than others. This challenge is not unique to CDC, but also present in DB schemes, annuities and other financial products such as insurance.[18]

CDC schemes must be compatible with the wider pensions landscape

In order to be adopted widely, CDC schemes will need to be compatible with the wider UK pensions landscape. This includes existing features of the landscape, such as automatic enrolment and pension freedoms, as well as future features currently under discussion, such as the lifetime provider model.

Compatibility with pension freedoms primarily relates to members' right to transfer out of the scheme. For members of DC schemes, transfers are relatively simple as they have an individual account of savings based on their own contributions and investment growth. For members of DB schemes, transfers are slightly more complex and require an actuarial process to assess the cash equivalent transfer value that will be paid to the transferring member in exchange for giving up their benefit entitlement; this is calculated on the basis of the expected cost to the scheme of delivering the member's promised pension income.

Members of CDC schemes will be entitled to transfer out, but will receive a share of the collective fund rather than a cash equivalent transfer value. When identifying an appropriate transfer value, CDC schemes will need to take into account the total value of the fund and its investment and longevity profile in order to be fair to both the transferring member and members that remain in the scheme.[19]

Freedom to transfer out of CDC schemes may lead to selection risks. For example, people with shorter life expectancies may be less likely to participate. As automatic enrolment makes participation the default, this may not be a significant problem if opt out rates remain low. However, if a CDC scheme is perceived to be unfair or underperforming, opt out rates and transfers out of the scheme are likely to increase, which could have an impact on scheme sustainability, although all CDC schemes are required to have robust continuity plans in place as a requisite for authorisation. International examples of CDC schemes rely on mandatory membership to support their sustainability, but membership of UK schemes will be voluntary so the potential for transfers out must be accounted for. However, relatively low levels of opt outs that have persisted since the introduction of automatic enrolment despite turbulence in the economy and cost-of-living increases, could be extrapolated to suggest that the level of transfers out of CDC schemes are unlikely to have a substantial impact on scheme funding and operation.

[18] DWP (2018) Impact assessment: Delivering collective defined contribution pension schemes
[19] DWP (2019) Government Response to the Consultation: Delivering Collective Defined Contribution Pension

The introduction of CDC schemes may also have an impact on the rest of the decumulation market

Once the primary method of accessing DC pensions, annuity sales have declined significantly since the introduction of pension freedoms in 2015. In 2012, over 90% of DC assets accessed were used to purchase annuities, and overall sales of annuities peaked in 2009 at around 466,000.[20] Since then, they have been declining. When the pension freedoms were introduced, annuity sales declined more rapidly, averaging around 70,000 a year throughout 2016 to 2019. 2020 saw a further sharp decline in annuity sales, with just 49,000 sold over the course of the year, as a result of the pandemic increasing annuity prices, making annuities less attractive, and people delaying retirement because of the pandemic's negative effect on their savings. Since then, annuity sales have increased but remain well below pre-pandemic levels at less than 55,000 a year.[21]

Decumulation-only CDC schemes in particular may have a further impact on the annuities market, as the income provided by a CDC scheme may appear similar to an annuity to the average saver, but is likely to be more generous as there is not the premium associated with providing a guarantee. Introducing another product to the decumulation market could also make decisions more confusing for the average saver. Ensuring that customers understand the difference between annuities and CDC, in terms of benefits and risks, will be an essential component of introducing decumulation-only CDC to the market. It will be important to consider where decumulation CDC is positioned within the advised and guided markets, and how decumulation CDC should be positioned between the certainty of an annuity and the flexibility of an individual drawdown product, including the potential role of CDC in hybrid decumulation solutions which incorporate multiple products.

Conclusions

As the first UK CDC scheme, the Royal Mail Collective Pension Plan, prepares to open to members, the future of CDC across the rest of the pensions landscape is still unclear. CDC schemes have the potential to provide a more cost-effective way for employers to provide their employees with an income in retirement, and for members could offer better retirement outcomes with less need for individuals to make complex decisions about how to save and access their savings. However, appetite for CDC schemes is currently limited, with the exception of the Royal Mail scheme. CDC may be an appealing alternative for DB schemes, but few remain in the private sector, and those that do may be hesitant to make the transition unless it is not feasible to continue with existing DB provision. For employers with DC provision, awareness of CDC is low and there may not be an obvious benefit for these employers, beyond potentially improving employees' retirement outcomes, which may not be a top priority. Further appetite for CDC may materialise once the Royal Mail scheme is embedded within the system and as alternative scheme designs, such as multi-employer and decumulation-only CDC, are brought into legislation.

[20] ABI data
[21] ABI data

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The next Briefing Note in this series will build on the findings of this Briefing Note to assess who may benefit from the introduction of CDC, how these benefits may be realised, and the challenges of doing so.

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